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On November 3, 2020, California voters narrowly approved Proposition 19 (The Home Protection for Seniors, Severely Disabled, Families, and Victims of Wildfire or Natural Disasters Act) and with it comes significant property tax changes for California real-property owners.

First, Proposition 19 severely limits the conditions under which property owners can transfer California real property between parents and children without triggering property tax reassessment. This update focuses on this aspect of Proposition 19, as property owners can decide whether to engage in advance planning under the more favorable current rules before the more restrictive new rules go into effect on February 16, 2021. Second, Proposition 19 expands the ability of persons who are age 55 years or older, disabled, or victims of a wildfire or natural disaster to preserve and transfer the assessed value of their primary residence to a replacement primary

residence. No advance planning is necessary to obtain these expanded benefits provided by Proposition 19, which will be briefly summarized at the end of this update.

Parent-Child Exclusion From Reassessment

Background

Under Proposition 13, which was passed by 64.79% of California voters on the June 1978 ballot, California properties are taxed based on their assessed value (also known as the base year value or taxable value) rather than their fair market value. Assessed value is generally the purchase price and cost of improvements, plus an increase of no more than 2% per year unless and until there is a change in ownership. Because California real estate, on average, has appreciated in value at a rate higher than 2% per year, the longer a property is held, the greater the difference between its assessed value and its fair market value, and thus the greater the difference between the amount of property tax its owner pays as compared to the owner of a newly purchased property of equivalent value. Proposition 13 will remain the current law even after Proposition 19 goes into effect.

Current Law

Transfers between spouses are exempted from the change in ownership rule (and thus from property tax reassessment). In addition, Proposition 58, which was passed by 75.7% of California voters on the November 1986 ballot, excludes from reassessment transfers between parents and children of the transferor's (a) primary residence, regardless of value, and (b) \$1 million of assessed value of other real property (such as second homes and investment properties).[1] Proposition 58 is commonly referred to as the parent-child exclusion.

The parent-child exclusion is most favorable to families that have long-held California real property with low assessed values thanks to Proposition 13. For example, a 60-unit apartment complex in the San Francisco Bay Area purchased by a married couple in 1979 may have an assessed value just under \$2 million, although the fair market value of the building is \$20 million. Under Proposition 58, the couple could transfer this property to their children without reassessment. (Each parent can transfer property with \$1 million of assessed value, and together they can transfer property with \$2 million of assessed value.) In addition, the couple could transfer their primary residence to their children without reassessment, regardless of the assessed value.

New Rules Under Proposition 19

Proposition 19 replaces Proposition 58 and greatly limits the scope of the parent-child exclusion. Beginning on February 16, 2021, (a) the ability to transfer \$1 million of assessed value of other property (i.e., property that is not one's primary residence) is completely eliminated, and (b) the ability to transfer a primary residence[2] between parent and child without reassessment will not apply unless two conditions are met: (i) the primary residence must also become the recipient's primary residence, and (ii) the fair market value of the primary residence at the time of transfer cannot exceed the transferor's assessed value by more than \$1 million.[3] If, at the time of transfer, the difference between the assessed value and the fair market value of the home exceeds \$1 million, the new assessed value will be the fair market value less \$1 million.[4] If the transferor's primary residence does not become the recipient's primary residence, then the property will be reassessed to its fair market value. See the chart on the California Board of Equalization's website for a side-by-side comparison of the parent-child exclusion pre- and post-Proposition 19: <https://www.boe.ca.gov/prop19/>.

Application and Illustration

The following example illustrates how Proposition 19 changes the parent-child exclusion.

A parent owns a home that is her primary residence and a rental property (such as an apartment building or commercial building) in California. The home has an assessed value of \$500,000 and a fair market value of \$3 million. The rental property also has an assessed value of \$500,000 and a fair market value of \$2 million. Even though the properties have different fair market values, their property tax liability is similar because they have the same assessed value. The combined annual property tax of both properties with a property tax rate of 1.25% is \$12,500.[5] The parent wants to transfer both properties to her daughter.

Result Prior to Proposition 19: There is no reassessment on the transfer of either the home or the rental property from parent to daughter. The home can be transferred to the daughter regardless of its value because it is the parent's primary residence, and the assessed value of the rental property falls below the \$1 million threshold. Therefore, the combined annual property tax will remain \$12,500. There is also no restriction on the daughter's use of either property and the daughter may use both as investment properties if she so chooses.

Result After Proposition 19: There is an adjustment to the assessed value of the home and a full reassessment on the rental property. The new assessed value of the home is \$2 million because the fair market value exceeds the assessed value by more than \$1 million (in that case, the calculation for the new assessed value is the fair market value of \$3 million less \$1 million). The new assessed value for the rental property is its fair market value of \$2 million because no exemption to reassessment applies for transfers of real property from parent to child other than the primary residence. The new combined annual property tax will be \$50,000. In addition, the daughter must use the family home as her primary residence or else the home will be reassessed to its fair market value of \$3 million, which would increase the combined annual property tax for both properties to \$62,500.

Planning Opportunities

Under the mechanics of Proposition 19, planning done between now and February 15, 2021, can lock in the current parent-child exclusion rules. Because of the fast-approaching deadline to do this planning, property owners who wish to transfer their California real property to their children without property tax reassessment should contact legal counsel as soon as possible to discuss their current options. This is especially important for parents who expect their children will keep rather than sell their California property. In addition, anyone who has transferred California real property to a qualified personal residence trust (QPRT) that has not yet terminated should contact legal counsel as soon as possible because property held in a QPRT is not protected from Proposition 19.

Properties Held in Legal Entities

It is important to note that the parent-child exclusion rules discussed in this update do not apply to properties held in legal entities such as limited liability companies, partnerships, and corporations. There is a separate set of rules for determining when there has been a change in ownership (and thus property tax reassessment) of properties held in legal entities. Property owners who hold title to California real estate in legal entities that they wish for their heirs to keep rather than sell should consult with legal counsel for analysis of how these rules apply in their circumstances. To avoid inadvertently triggering reassessment, property owners should also

consult with legal counsel before transferring real estate into or out of legal entities, and before making intrafamily transfers of interests in legal entities that own California real estate.

Transfer of Assessed Value to New Primary Residence for Persons Who Are Age 55 and Over, Disabled, or Victims of Wildfire or Other Natural Disasters

The second element of Proposition 19 will take effect on April 1, 2021, and provides that persons who are over 55 years of age, disabled, or victims of a wildfire or natural disaster may transfer the assessed value of their California primary residence to a newly purchased or newly constructed replacement primary residence in any county in California. The transfer of assessed value to a replacement primary residence can occur up to two years after the sale of the original primary residence and applies even if the replacement primary residence has a higher fair market value than the original primary residence (but in that case, the excess fair market value of the new home will be added to the assessed value of the old home to arrive at the new assessed value for the new home). In addition, an eligible homeowner can take advantage of the assessed value transfer up to three times during his or her lifetime.

Endnotes

[1] In limited circumstances, when all the parents of a grandchild are deceased, assessed value may be preserved in transfers from grandparents to grandchildren (Proposition 193). For purposes of this update, all references to transfers from parents to children shall also apply to transfers from grandparents to grandchildren in these limited circumstances. The parent-child exclusion also applies to transfers from children to parents, and transfers to or from certain trusts.

[2] In addition to primary residences, Proposition 19 also applies to family farms.

[3] The \$1 million limit will be adjusted every other year beginning on February 16, 2023, based on the House Price Index for California in the prior calendar year.

[4] Adjusted as described in footnote 3, above.

[5] An estimated property tax rate of 1.25% will be used for all illustrations.

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